



EMERGING MARKETS - REASONS TO BE CHEERFUL

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BAILLIE GIFFORD

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Annual Past Performance (%) to 31 December Each Year

	2015	2016	2017	2018	2019
Emerging Markets – Institutional Funds Unconstrained	-8.4	2.7	53.2	-15.1	27.9
Emerging Markets – Leading Companies Institutional	-9.5	5.5	53.0	-16.4	30.9
MSCI Emerging Markets	-14.6	11.6	37.8	-14.2	18.9

Source: Baillie Gifford & Co and relevant underlying index provider(s).
Net of fees in USD.

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Will joined Baillie Gifford in 1999 and is an Investment Manager in the Emerging Markets Equity Team. He became a Partner of the firm in 2010. He is a member of the Positive Change Portfolio Construction Group and has also spent time working in the UK and US Equities Teams. In addition to his investment responsibilities, Will oversees Baillie Gifford's investment graduate recruitment programme, and is a member of the firm's Diversity and Inclusion Group. Will graduated MA in History from the University of Glasgow in 1996.



APRIL 2018

EMERGING MARKETS – REASONS TO BE CHEERFUL

BY WILL SUTCLIFFE



At the beginning of 2017, we wrote a piece entitled ‘Morbid Symptoms’, in which we explained why – at a time when political events in the West had left most commentators in a state of confusion – we found ourselves more optimistic about a broader range of emerging market (EM) equities than had been the case for a number of years. The title of that piece was a nod to the Italian philosopher Antonio Gramsci who, despite having plenty to be grumpy about – he struggled with poverty and ill-health from birth, and spent the last quarter of his life in prison at the hands of Mussolini’s fascists – famously referred to the fact that he was ‘a pessimist by intellect, but an optimist by will’. We needn’t be unrealistic about challenges ahead. But nor should we dismiss those who are prepared to look on the bright side as starry-eyed Panglossians.

One year on, our sense of optimism remains. We say this not to draw attention to any good fortune in timing: forecasting short-term gyrations in markets has never been our speciality. We say it because our optimism still feels at odds with much of the expert opinion from commentators and financial journalists. In recent months, for example, headlines in the Financial Times have warned us that ‘Emerging Markets Face a Testing 2018’ after their recent period of outperformance, while BCA Research continues to warn of the ‘formidable headwinds to EM risk assets’. For some pundits, fears are centred on the possibility that rising interest rates in the US will drive the sort of rally in the dollar that has tended to be bad news for EM. For others, it’s the risk of contagion from China, where policy has been

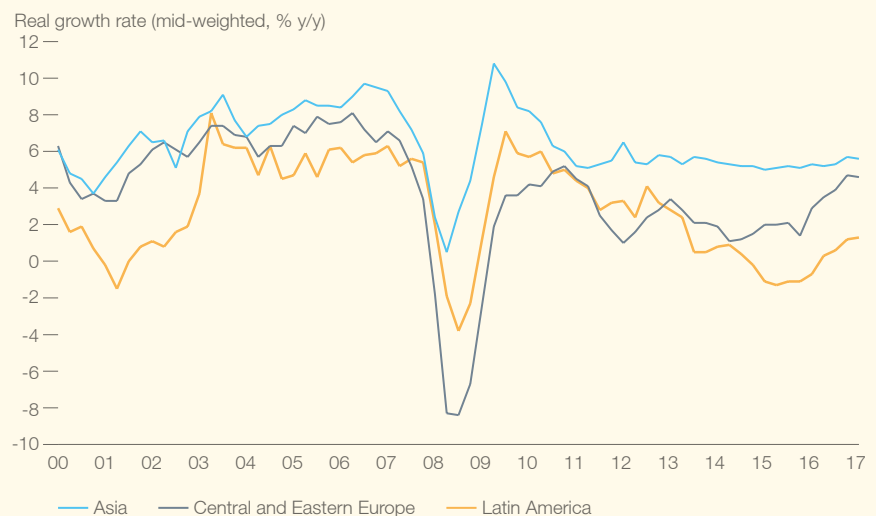
tightening at a time when growth in the other BRICs remains elusive. Where optimism about the asset class is expressed, it seems to be phrased only in terms of the appeal relative to ‘over-priced’ US equities.

In that spirit, we’ve decided to pay homage to another dead optimist. This time, it’s the English musician Ian Dury who, like Gramsci, had plenty to be grumpy about: growing up in extreme poverty at a time of record unemployment in the UK, and disabled by polio from the age of seven. Yet Dury is probably best remembered for his 1979 song, *Reasons to be Cheerful (Part 3)* – a list of more than 60 reasons to look on the bright side. Since we lack Dury’s gift for laconic wordplay, we’ll restrict our own ‘EM Reasons to be Cheerful’ to five.

1. GROWTH EVERYWHERE

For the first time in 10 years, the global economy is firing on all cylinders. More importantly, given the lags between the policy response in the US and elsewhere, this is a relatively de-synchronised expansion: full-blown monetary stimulus only reached Japan in 2013 and the EU in 2015, while several EM economies have only begun to ease policy within the last year or two. In Brazil, for example, interest rates have come down from 14% to below 7% over the last 18 months, in Russia they have fallen from 11% to 7.5%. In other words, there are a significant number of emerging economies where the worst of the economic contraction appears to be past, and they are now entering into the ‘sweet spot’ that the US has been enjoying for much of the last five years, where profits are rising but policy remains highly accommodative.

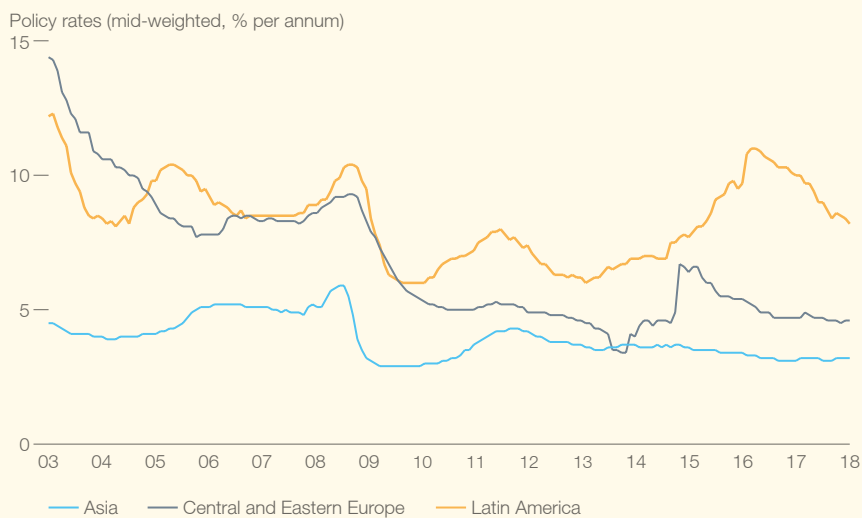
Real GDP Growth by Region



Source: Emerging Advisors Group. Data to end December 2017.



Policy Rates by Region



Source: Emerging Advisors Group. Data to end February 2018.

Of course, we can debate the amount of staying power left in the US expansion, or the likely timing and magnitude of Federal Reserve (Fed) monetary tightening. However, while the ‘rising rates = rising USD = bad for EM’ mantra may be appealingly simple, there’s not much evidence it works in practice. If anything, during most of the Fed tightening cycles that have taken place in recent decades, the dollar has actually tended to weaken. This makes sense, for two reasons that remain relevant today: first, the dollar has often already appreciated in anticipation of tightening by the time rates actually start to rise, and second, capital flows are influenced by returns on capital invested in the real economy and therefore sensitive to cyclical economic conditions, not just interest rate differentials. This isn’t to say that we have any particular insights on where the dollar is going; it’s simply that we don’t think it makes much sense to be gloomy about EM just because rates might be going up in the US.

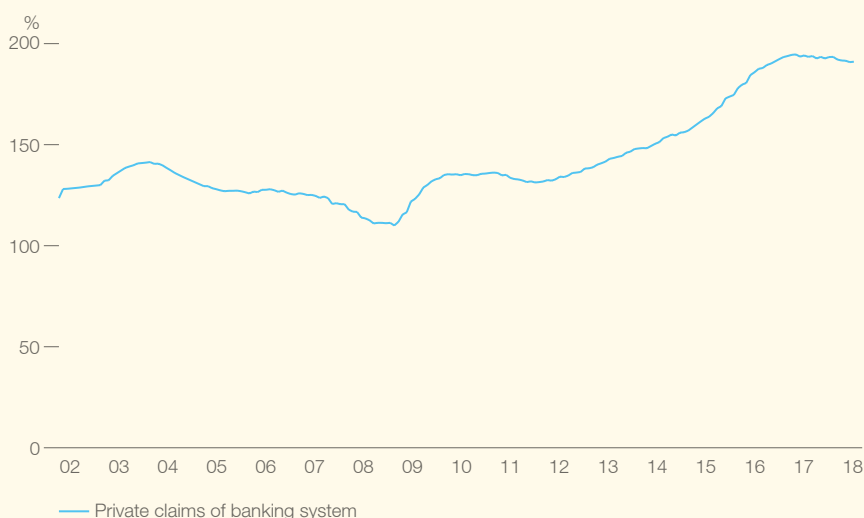


2. CHINA FAILS TO IMplode (AGAIN)

China has a long history of defying the pessimists. Ever since Deng Xiaoping launched the era of reform and opening in 1978, people have been predicting disaster: too much debt, too much corruption, not enough reform, not enough entrepreneurial vigour. Each of these arguments is losing traction.

Over the past couple of years, the market has been preoccupied with the risk of a meltdown in China's banking system. We've always thought this was an odd thing to worry about. True, buying growth with large dollops of debt tends not to be something that an economy can sustain indefinitely, but when that economy has a closed capital account, a sky-high savings rate, and a government that owns most of the lenders as well as most of the problem borrowers, the music can keep playing for a lot longer than it might in a 'normal' economy. However, the real surprise of 2017 was how adept Beijing was shown to be in cutting back lending to the riskier parts of the economy, while keeping credit flowing to worthy borrowers. Xi Jinping is clearly serious about reducing financial risk, and with the target that he was bequeathed by his successors to double GDP by 2020 now pretty much

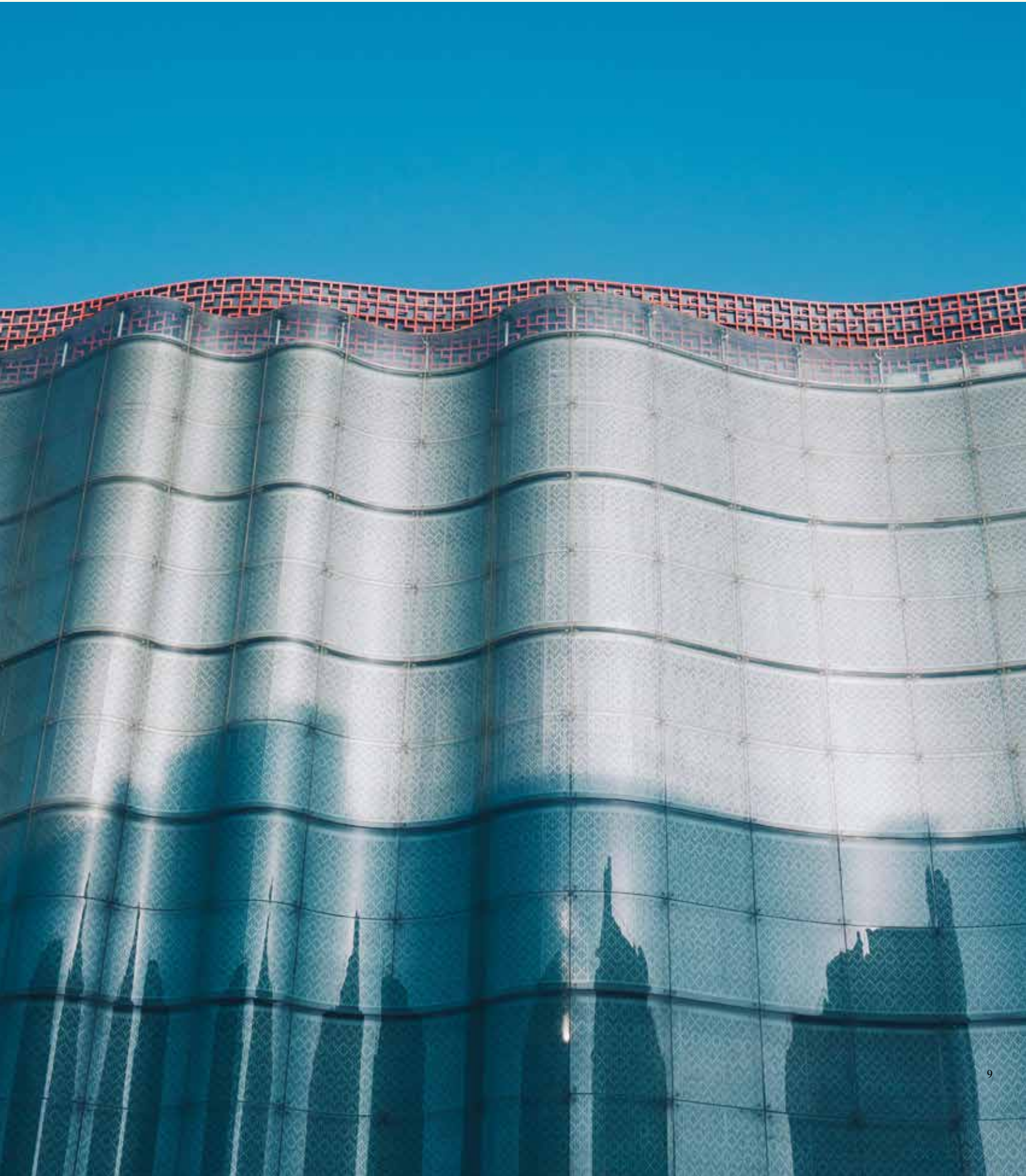
Outstanding Credit as a Share of Chinese GDP (%)



Source: Emerging Advisors Group. Data to end February 2018.

in the bag, economic growth will continue to be de-emphasised as a political priority. For sure, this throws up plenty of interesting questions about the nature of those priorities, especially as it is now clear that the Xi Jinping era is only just beginning. But, for an economy whose most dynamic parts are now dedicated to producing consumer efficiencies rather than large chunks of GDP, it shouldn't come as a surprise.

Experts will continue to make a living from warning us of all the risks. As psychologists such as Steven Pinker point out, it's the sort of thing that plays to our morbid obsession with what might go wrong. Suggesting that China will gradually and uneventfully grow into its balance sheet is hardly the sort of thing that's going to titillate markets. But, in our judgement, this remains the most likely scenario.



3. THE DIGITALISATION OF EVERYTHING

For a number of years now, one of our key contentions has been that underdevelopment of offline alternatives will drive a relationship between EM consumers and the mobile internet that is far more intensive than anything we are likely to see in more ‘advanced’ economies. Evidence to support this contention continues to accumulate. Indeed, the pace of change has been accelerating: Tencent grew its profits by more than 70% in 2017, compared to growth of 30% p.a. between 2011 and 2016. For Alibaba, it was 125% last year after 54% p.a. in the previous five. For sure, the most frenetic growth is in China, but something similar is happening across much of EM – witness MercadoLibre, where sales are currently growing at close to 50% year-on-year, nearly double the pace of recent years. Share prices may have risen, but competitive moats have been broadening and deepening.

The success that companies such as Alibaba and Tencent have had in encouraging consumers to shift more and more of their lives online is way beyond anything that their Silicon Valley peers have managed. Or, as the author Duncan Clark memorably put it: “When you leave China these days, it can feel like you are travelling back in time”. When we add in the fact that these companies are not only tolerated by the authorities, but actively encouraged, the comparison with the western platforms becomes even starker.

Of course, we must be careful not to conflate operational excellence with substantial upside in the equity. But, with Tencent currently making an average revenue per user that is still a fraction of that made by the likes of Facebook or Netflix in the US, or Alibaba having only just begun to experiment in a fast-moving consumer goods industry that’s worth in excess of US\$1 trillion, our view is that these businesses are still in the early stage of the growth opportunity.

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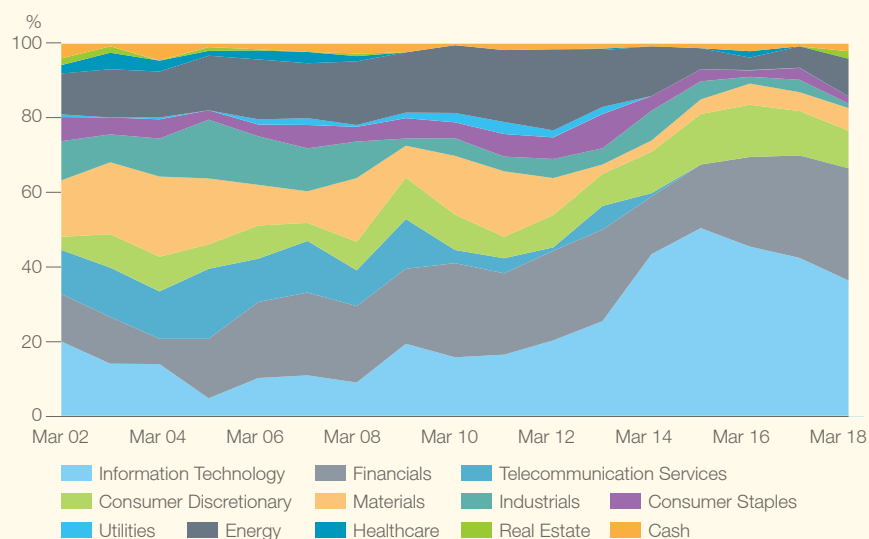
A screen shows Alibaba's GMV exceeding RMB 168.2 billion in the Single's Day Global Shopping Festival in November 2017.

© Visual China Group/Getty Images.

4. IT'S NOT JUST TECH

Clients are well aware of our long-standing enthusiasm for technology: the sector has accounted for as much as half of our GEM portfolios in recent years, and that's before we take into account holdings in technology stocks that the index providers classify as consumer discretionary. While this was largely a function of our excitement about the outlook for stocks exposed to some of the themes described above, it also reflected a relatively cautious view on the investment prospects for much of the rest of the EM universe.

Historic Sector Allocation – How Has The Portfolio Changed Over Time?

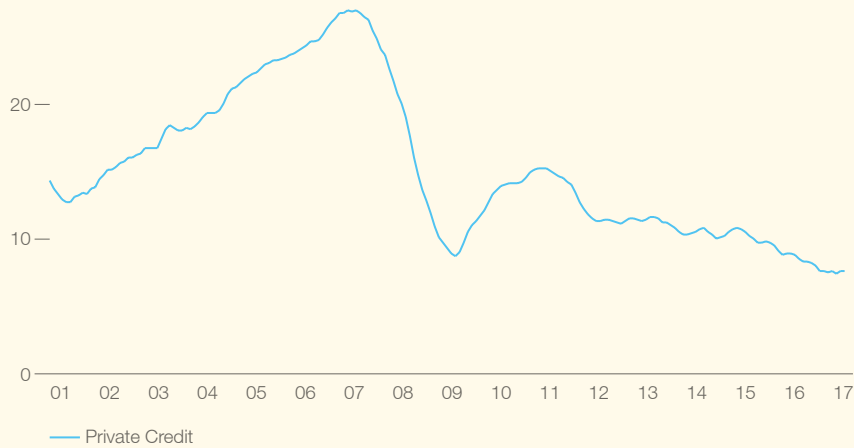


Source: Baillie Gifford & Co. Based on a representative EM All Cap Portfolio.

This has been changing. With credit growth at multi-decade lows in a number of emerging economies, but banking systems generally in good shape, we have substantially increased the exposure of our portfolios to a number of our favourite banking franchises in structurally underpenetrated markets. In fact, the relative weighting of the financials sector within our GEM portfolios is now at its highest level in a decade. And it's not just the banks that have been catching our eye: the stabilisation in commodity prices provides a more supportive external environment for several emerging economies that our portfolios have had relatively little exposure to in recent years, and opens up the possibility of an inflection point in dollar earnings for a number of consumer-facing companies operating in these parts of the world.

EM Credit Growth

Growth (mid-weighted, % y/y 3mma)
30 —



Source: Emerging Advisors Group. Data to end December 2017.

As we wrote last year in ‘Morbid Symptoms’, we don’t believe that the more favourable environment for global growth is enough in itself to kick-start another commodity super-cycle – after all, the importance of China’s investment cycle for steel, cement and a variety of other industrial commodities suggests that peak demand is probably behind us. However, there may be exceptions. Oil, for example, is one commodity where China remains a relatively small proportion of global demand, while even new-economy cheerleaders such as ourselves accept it will be a very

long time before electric vehicles take over in markets like India. Indeed, with crude inventories at relatively low levels, questions over the ability of shale to respond to higher prices, and Saudi’s apparent desire to ease the succession of Mohammed Bin Salman with an unofficial floor of US\$60 a barrel, the odds of an extended period of elevated oil prices strike us as reasonably high. Given the disproportionately large number of assets in our universe that might benefit from such a scenario, it’s a topic that we have been giving serious consideration.



5. *A LOST DECADE*

While EM equities have enjoyed a decent period of relative outperformance over the last year or so, it's worth reminding ourselves what a laggard the asset class has been over the long term. After all, the MSCI EM index isn't much higher than it was a decade ago in dollar terms, and remains some way below the 2007 peak.



Source: MSCI EM Price Return. Data to end March 2018.

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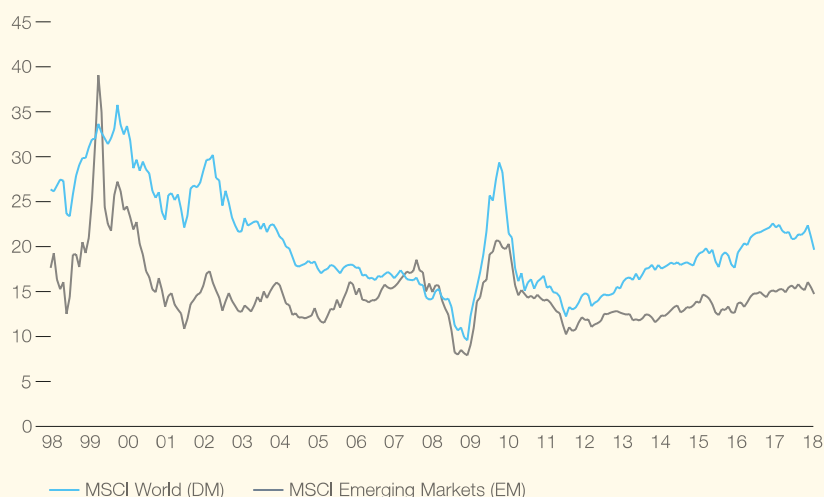
We point this out only as a reminder of the longer-term context for any investors who have found themselves suffering from vertigo. Whether the asset class is ‘cheap’ or not is a question others are better equipped to answer. Some will point to headline multiples that remain at historic lows relative to developed indices, others will caution that sector-adjusted comparisons look less enticing. For our own part, we can simply observe that when it comes to finding companies that meet our own investment criteria – that is, the potential for the share price to at least double in dollar terms within a five-year period – we find ourselves relatively spoilt for choice. Indeed, to the extent that our enthusiasms are coming from a broader range of sectors and countries than has been the case for a number of years, the current period feels to us more analogous with the early 2000s than it does with the late 1990s or the earlier part of the current decade.

There will come a time when our optimism is more fully reflected in market sentiment. But, when we look at the PE multiples attached to some of our largest holdings – single-digits for Sberbank or Samsung, low-teens for the likes of TSMC, Ping An or Reliance Industries – it’s hard to

escape the conclusion that it is fear, rather than greed, that remains the dominant market narrative.

Superb companies, with excellent growth prospects, trading on reasonable valuations? The good times are surely just getting started.

Developed Markets vs Emerging Markets P/E Ratio



Source: Thomson Reuters. Data to end March 2018 and in US dollars.

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